# 5. The Inflation Problem

5.1 In the course of the past decade inflation has come increasingly to dominate the international scene. In the 1950s it remained around 3 per cent in most OECD countries and was only slightly higher in the 1960s. But in the 1970s it increased sharply and is now in double figures in many of the major industrialised countries. Many of the developing countries have also suffered from high and accelerating inflation.

5.2 This acceleration coincided with the increase in oil prices in 1973-74, just as the more recent acceleration of inflation in 1979-80 coincided with a fresh increase in oil prices. But oil was not the primary cause in either case. Rather it followed and reinforced a general price rise that was already in progress. Moreover, although every country had to face the steep rise in oil prices, the rate of inflation did not show an equal response in every country. In Germany and Japan, for example, the acceleration after 1973 was comparatively mild while in the United Kingdom and Italy it was very much greater.

5.3 The movement in commodity prices which was the most prominent symptom of inflation in 1973-74 was caused by a combination of circumstances: a boom in the industrialised countries; the monetary expansion of the early 1970s and the search for alternative assets and the commodity speculation to which this led; the break-up of fixed exchange rates; and an abnormal grouping of harvest failures. It is not necessary to investigate the relative importance of each of these or the manner in which they interacted with one another. It is material, however, that the rise in one set of prices was not offset by a fall in other prices. On the contrary, the efforts of income-earners in the industrialised countries to avoid the reduction in their real incomes implicit in the rise in input prices were reflected in larger wage-claims and in due course in larger wage-settlements, and monetary and fiscal policies tended to respond to those pressures. Added to this, the strain of a higher import-bill on some of the weaker currencies forced down the value of those currencies and magnified the movement in commodity prices when expressed in those currencies. Thus what started as a shift in the terms of trade that had no inescapable consequences for the general level of prices was translated, via currency devaluation, 'real-wage resistance' and permissive monetary policies, into an alarmingly high rate of inflation. On the other hand, those countries that accepted more readily the burden of higher commodity prices or whose currencies were not depreciated suffered less severely from an acceleration in inflation.

5.4 Whatever the causes of the acceleration in inflation it has had harmful effects on growth. Some would emphasise direct effects. Inflation distorts the calculus of economic decision-making by disturbing established price relationships and introducing additional uncertainty. It becomes much harder to assess the return on new investment and to plan for the future with confidence. Inflation also plays on the fears of those who are hit by it and creates resentments towards those who benefit.

5.5 Others would regard the indirect effects of rapid inflation on economic activity and growth as more important. These come about through the changes in the attitude and policy of governments as inflation takes hold. Governments become increasingly willing to acquiesce in a slowing down of growth as a means of keeping it under control. They are alarmed both by the acceleration that has occurred and by the spread of inflationary expectations. The first of these makes the control of inflation more urgent amd the second makes it more difficult. The more inflation is taken for granted the harder it is to shake it off or keep it within limits. Interest rates rise to reflect the expected change in the value of money and borrowers acquire a vested interest in a rate of inflation that depreciates their debt obligations on the scale expected. Similarly wage-earners enter claims based on their experience of inflation in the recent past and so perpetuate past rates. With budgets already in deficit, partly because of the depressed level of economic activity, governments are reluctant to sanction increased government spending or carry tax reductions much beyond offsetting cuts in expenditure.

5.6 Domestic demand management policies can have serious repercussions on other countries. For example, when the United States in 1929 pushed up interest rates it did so in order to get on top of a speculative boom, but in the process it attracted funds from all over the world and forced deflationary policies on other countries at just the wrong moment. The same thing could happen again if large countries use monetary restraint to check inflation without regard to the resulting capital flows and their effects in forcing weaker countries to contract credit in difficult circumstances. Conversely, excessively expansionary policies in the United States are widely believed to have been a major factor behind the acceleration of inflation throughout the world economy in the years 1970-1972 and again in 1977-1979.

5.7 The relative emphasis placed on the direct and indirect effects of inflation on growth and on the dangers to other countries of excessively lax or excessively stringent demand management is at the heart of the current controversies between two schools of thought. The monetarist school attaches importance to the growth of money supply as a causal or at least a permissive factor in inflation, and to monetary restraint as an essential remedy. Their opponents attribute inflation mainly to excessive income claims and believe that monetary restraint cannot by itself make enough impact on inflation to justify its adverse effects on economic activity and employment.

5.8 On the one hand, are those economists who would favour operating on the money supply as a means of resisting inflationary pressure, and on the other hand are those who would seek to operate directly on costs and particularly on wage-settlements. From this point of view it hardly matters whether the monetary or the fiscal ingredient in demand management is uppermost in the minds of policy-makers. If inflation can be controlled by operating on demand, and if the control of inflation takes precedence over other aims of policy, then it is difficult to justify expanding demand under inflationary conditions. On the other hand, if wages go their own way without much regard to the level of demand, then action to restrict demand, monetary or fiscal, will merely depress economic activity without slowing down the rate of inflation.

5.9 The difference in analysis between the opposing views can be illustrated in terms of the macro-economic impact to be expected from a rise in oil prices. Most economists, and particularly those reared on Keynesian ideas, would expect such a rise, or indeed any general rise in import prices, to be passed on to the consumer so that the resulting increase in the cost of living reduced consumer purchasing power. They would then predict that, in the absence of government intervention, there would be a simultaneous fall in profits and job opportunities and a rise in current wage claims to make good the reduction in living standards. Given the attitude and bargaining power of the trade unions, they would expect to see employers yield to these claims, to some degree at least, so that price inflation received a further stimulus. Meanwhile, the government, confronted by rising unemployment, would be likely to acquiesce in the loss of revenue and higher outgoings involved in the lower level of economic activity and consequent unemployment; and it might even seek to offset some of this contraction by additional spending and a still higher budget deficit. If the oil producers were slow to absorb their increased earnings in higher living standards or domestic capital formation, the upshot would be that the industrial world as a whole would end up by borrowing back what was not absorbed and using the oil producers' extra savings to finance budget deficits in the public sector and producers' losses in the private sector of their various economies. The use of extra savings would help to keep up real income and consumption levels above what could be afforded in the longer run. Under these conditions inflation of prices would have failed to achieve its fundamental purpose of choking-off demand in conformity with the adverse movement in the terms of trade. The position would remain one of disequilibrium, reflected on the one side in higher earnings not fully absorbed and on the other in distress borrowing, illusory expectations of undiminished real incomes, and inflation as the expression of the disproportion between illusion and reality.

5.10 A monetarist would take a more radical view of the situation. He would point out that if one price or set of prices goes up, this may require (or cause) other prices to come down if stability in the price level is to be preserved. He would deny that there is some basic or underlying rate of inflation that must be taken for granted and to which fresh inflationary impulses from outside the system can simply be added. To accept such an assertion would amount, as the GATT Report for 1978/79 contends, to "an abdication of government responsibility in the face of inflation".[1] Similarly, if the steeper inflationary trend is then built into wage settlements, this will prove self-defeating if the central bank stands firm and refuses to 'validate' excessive increases in wages by increasing the money supply. No doubt this refusal will bring about higher unemployment; but the alternative of fuelling inflation will in the end do more harm to growth and employment.

5.11 It is also contended by monetarists that a rise in oil prices need exercise no serious and prolonged deflationary influence on economic activity in oil-importing countries. If all that is involved is a change in the terms of trade between oil-exporting and oil-importing countries, the impact on world economic activity should, they argue, be small and transitional. To the objection that severe deflationary forces could be unleashed if the OPEC countries were to accumulate large liquid funds, monetarists would reply that there is indeed a danger of cumulative recession. But it arises from the possible inability or unwillingness of oil-importing countries to finance balance of payments deficits, pending correction of such deficits through structural adjustment. So long as the OPEC countries continue to run current account surpluses, the proceeds must be held, that is to say lent and spent, somewhere.

1. GATT: *International Trade 1978/79* (Geneva, 1979), page 15.

5.12 The difference between the two views largely reflects different judgements about facts which are uncertain, though differences of analysis and 'paradigm' also play a part. We cannot pretend to be able to resolve them. In the context of policy, the underlying issue is at what cost inflation can be halted or at least slowed down. The monetarists emphasise the need for monetary restraint and treat any unemployment arising on the way as a necessary and temporary price. Non-monetarists are reluctant to accept any degree of monetary restraint without regard to the severity of its effect on economic activity and employment. They accept trade union attitudes and other competing claims on resources as a fact of life in western societies and seek remedy in some form of incomes policy, as the only alternative to insupportable contractions of income and employment.

5.13 The correct mix of policies, monetary or non-monetary, can only be decided by governments. There are no universal or agreed solutions and policies are likely to vary from country to country depending partly on political and institutional factors. Whatever may be the best mix of policies from the national point of view, it is appropriate to stress that due account must be taken of the effect of these policies on other countries. Policies conceived in purely domestic terms may be neither appropriate nor effective.

5.14 One point that can be made emphatically is that the control of inflation, whether on a domestic or a world-wide basis, demands more effective management of domestic economies and more concerted effort to regulate the world economy through new international arrangements. In this connection, we would like to underline the following suggestion by the United Nations Committee for Development Planning at its meeting in January 1980:

> "Greater predictability and longer term assurance in the prices and supplies of commodities in the 1980s would also make a useful contribution to a more stable and positive international economic environment. . . . New efforts should be made over the coming years, recognising the need for such agreements to cover greater stability and predictability of real prices as well as greater security of supplies, and to cover a number of major commodities not just oil or energy."[1]

5.15 Inflation, to sum up, poses a serious threat to the prosperity and growth of the world economy. It represents a failure of economic management that will be costly to remedy and the cost will not fall only on those countries where the failure has been greatest. Each country has to wrestle with the problem in terms of its own local circumstances and priorities. But

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1. United Nations: *Committee for Development Planning: Report on the Sixteenth Session* (New York, 1980), paragraph 27.

it is to be hoped that in their efforts to put an end to one evil, countries do not lose sight of their obligations to one another or of the even greater evils that might be let loose on the world by too single-minded, over-zealous and wrong-headed remedies.